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THE SECRETARY OF TRANSPORTATION

WASHINGTON, D.C. 20590

May 13, 1982

Honorable William J. Casey Director, Central Intelligence Agency Washington, D.C. 20505

Dear Bill:

Pursuant to our conversation, you might find the attached article by Jude Wanniski interesting.

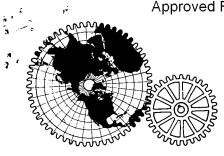
I hope all is well with you.

Sincerely,

DL/ckj

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Political and Economic Communications

The Political Economy in Perspective

THE DEFICIT THEORY

By Jude Wanniski

The theory that current and projected federal deficits are *causing* the recession through high interest rates has now overtaken the President. Although the theory is not supported by any academic school nor by evidence, it now engulfs almost the entire Establishment, as it did exactly fifty years ago. A Mob psychology has gripped Washington and Wall Street in a parallel of the mood against which the Revenue Act of 1932 was passed. The Mob has concocted the \$182 billion federal deficit projection for fiscal 1983 as its main lever, a deficit that can be reached only if the Mob's policies are embraced. At full employment, though, the current economy yields an extra \$400 billion in real output, covering any projected deficit. The House Republicans, behind Kemp-Gingrich, can block a 1932 replay, but perhaps only if the Stockman projections are discredited.

May 4, 1982

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THE DEFICIT THEORY

Last August, it was facetiously suggested in this corner that the "public flogging of Beryl Sprinkel would do wonders for the bond market." That is, as long as Sprinkel remains Treasury Undersecretary for Monetary Affairs, his mentor, Milton Friedman, will continue to dominate monetary policy in the Reagan Administration with his single-variable, money-supply model. The idea that the national economy can be managed to an optimum condition by control of a defined quantity of money — without regard to either the price of money or the demand for money — is the equivalent in geometry of trying to determine three sides of a triangle with only one side given.

It takes a certain kind of intelligence to believe in single-variable models anyway. But Sprinkel seemed totally unashamed on April 28 when, in announcing Treasury's quarterly refunding needs, he acknowledged the possibility of a second variable in his model. According to *The Wall Street Journal* of April 29, Sprinkel "said stabilization of money-supply growth and reduction of projected federal deficits over the next several years were the most important elements in bringing interest rates down. If those can be accomplished, he said, there would be a 'significant' decline in interest rates over the next few months. He added that he doesn't believe there is a relationship between large federal deficits and high interest rates. 'But if the market believes it, that's all that counts,' he said."

In other words, if the market believes in the correlation and establishes the correlation, Sprinkel will observe the correlation and accept it, but he still won't believe it. It must be comforting to Treasury Secretary Regan to have at his side a flexible mind like Sprinkel's, which can accept on faith correlations that do not exist.

Then again, we can sympathize with Sprinkel on this point. He has to get along with the Mob in Washington that has come to believe in the Deficit-is-the-Root-of-all-Evil Theory, a competing single-variable model. The Deficit Theory has had such a demonic grip on the Mob that it has been prepared to crush anything in its path. If you do not at least pay lip service to the DT, as Sprinkel does, you are certain to be branded an enemy of the people these days. Senator Pete Domenici and his staff at the Senate Budget Committee are almost half-crazed with fear and loathing of the deficit projections. Enveloped by the force of darkness, they are the ringleaders of the Mob.

But there is plenty of credit to go around. Senator Bob Dole and Senate Majority Leader Howard Baker, Jr., are up front with their flaming torches, and Sen. Paul Laxalt has thrown in with them. David Stockman, who we have come to think of as Rosemary's Baby, has been relentless in fanning the flames. Jim Baker and David Gergen at the White House have become foam-flecked, as has Rep. Bob Michel and Rep. Jim Jones in the lower House. The madness, sadly, has spread to President Reagan, who opened his televised address on the fiscal 1983 budget impasse with the statement: "To get our economy moving again, it's imperative that we enact a Federal budget that will bring down deficits and bring down interest rates."

The Mob has embraced almost the entire national press corps, which of course reflects conventional wisdom, and it is now hardly possible to turn on the TV news without hearing from the Wall Street Deficit Theorists who are suddenly in great demand. Irwin Kellner, chief economist of Manufacturer's Hanover, is among the leading ranters and ravers along with David Jones of Aubrey Lanston and Edward Yardeni of E. F. Hutton. They have begun to outshout Henry Kaufman and Albert Wojnilower ("Dr. Doom and Dr. Gloom") in their dire forecasts tied to the Deficit Theory. Indeed, Kaufman has taken to sniping at monetarists lately and Wojnilower has become positively sunny in his outlook, waving aside the budget impasse as inconsequential and predicting a decline in interest rates anyway. Kellner of Manny Hanny, by contrast, warns of a 5- to 6- percent climb in interest rates because of the budget breakdown. Alan Greenspan, who helped father Rosemary's Baby, is still lurking in the shadows, always sounding reasonable in his ominous forecasts off the Deficit Theory, at least as long as he's sitting next to David Jones.

The fact that Beryl Sprinkel is right, that there is no observable correlation between deficits and interest rates, cuts no ice with the Mob. They know what they know. The most precious headline of the year reflected this intellectual eccentricity. It appeared on the first business page of *The New York Times* on April 30, over a story on the bond market's reaction to the budget. "IMPASSE DISMAYS BOND TRADE," it read, with a subhead in smaller type: "But Rates Don't Rise." Ah, the BOND TRADE is dismayed, but the market isn't. *The Wall Street Journal* was no better. "BOND ACTIVITY SLOWS AMID TRADER ANXIETY OVER IMPASSE ON FEDERAL BUDGET DEFICITS," headlined the bond column, which waited until the third paragraph to break the news: "Prices of most Treasury notes and bonds inched higher."

This was the story all through 1981 and David Stockman's budget victories, which should, according to Deficit Theory, have been accompanied by surges in bond prices but instead were greeted with yawns. Stockman's only defense of his Deficit Theory was that the markets really did not believe he was going to be successful in cutting spending.

Evidence doesn't count in this current madness, nor do correlations. The Deficit "Theory" itself is not so much a theory as a political weapon. How absolutely amazing it is that it could exist in this supposedly Keynesian world, flourishing to the point where the leading Keynesians of our time march under its banner. The very notion of raising taxes and cutting spending in order to climb out of the deep recession is antithetical to all Keynesian theory. Yet the prescription is embraced not only by the Wall Streeters, the commercial Keynesians, but also by the academics, the Brookings people, the Yale school, Lester Thurow. What do these people stand for?

We have to go back a long time before we find a similar period in history, when the Deficit Theory was so rampant that a President would make a bipartisan deal with a Congress of the opposing party to rationalize tax increases. In 1932, Herbert Hoover pushed through an enormous tax increase with the help of the Democrats at a time of 15 percent unemployment. The hike was to have increased projected revenues by one-third and balanced the budget. Of course, it merely lengthened unemployment lines and ballooned the federal deficit.

On December 8, 1931, in his State of the Union address, Hoover called for support of this tax program:

Our first step toward recovery is to reestablish confidence and thus restore the flow of credit which is the very basis of our economic life.

The first requirement of confidence and of economic recovery is financial stability of the United States Government.

Even with increased taxation, the Government will reach the utmost safe limit of its borrowing capacity by the expenditures for which we are already obligated and the recommendations here proposed.

Hoover's Treasury Secretary, Ogden Mills, followed up with a Deficit Theory speech to the New York Economic Club on December 14, 1931:

Our longterm bonds are selling today at a discount, even those bearing as high an interest as 3 3/4 percent. Allowing for tightened money conditions, and for all the unusual circumstances which surround us, there is no doubt that some of the weakness manifested reflects the response of the investing public to the possibility that we may be confronted with a rapid increase in the public debt, and in the volume of Government securities outstanding.

Herbert Stein, in whose book "The Fiscal Revolution in America" this history can be found, commented on the scene fifty years ago:

There is no need here to trace the Revenue Act of 1932 through the Congress. There was a long and bitter fight, but the fight was over the nature of the tax increase, not over the wisdom of raising taxes by such a staggering amount at a time of massive unemployment. Once the President and his financial experts had said that balancing the budget was imperative, there were few, in the Congress or in the country, who would take the responsibility for denying it. Some congressmen did rise to say that the tax increase was unnecessary, that the Treasury was having no difficulty in borrowing, that the debt was smaller than it had been ten years earlier, that the citizens would be better able to pay \$10 after the Depression than \$1 during it, and so on. But these were backbenchers or mavericks. For the Democratic leadership in the Congress the President's tax proposal was an invitation either to take responsibility for a big deficit or to share responsibility for a big tax increase. Their riposte was to support the idea of a tax increase, thus aligning themselves with "sound finance," but to attack the particular tax increase the President proposed as a "rich man's tax bill," thus escaping the wrath of the majority of tax payers.

- "Fiscal Revolution," p. 32.

Stein, of course, is the very same Stein who chaired Richard Nixon's Council of Economic Advisers in 1972-73, a position from which he loudly touted the "full-employment budget concept." This was an idea that had been kicking around the Committee for Economic Development since 1946, when Stein was associated with the CED. It held that the federal deficit should be as large as the extra revenues that would be collected if the economy were at full employment. This is pure "demand management" theorizing, and it does not address itself to tax-incentive effects or the composition of the deficit. But it was Herb Stein's baby and he pushed it hard.

It was Hegel who supposedly said that the only thing we learn from history is that we never learn from history. He could have said that it is often the historians who learn less from history than anyone else. Here we have Stein, who clearly observes the destructiveness of the incorrect policies of the 1930's, leading the same charge 50 years later. Indeed, Stein has not uttered a public word that I am aware of in these last few years that did not in some way harp against the federal deficits as a source of our difficulties and recommend tax increases as a solution.

Where are we on the full-employment budget concept now? At 4 percent unemployment, the usual guide, Robert Mundell reckons the economy would be producing \$400 billion more in goods and services than the \$3 trillion we are cranking out now. On the federal tax side alone, the extra \$400 billion in output would generate almost \$100 billion more in revenues. The decline in federal spending that would accompany full employment would be colossal — as would the pressures on the Government to spend. At full employment, there would be roughly \$100 billion surplus that the Congress could divide, paying down some of the national debt, repairing the highways, rebuilding the military, and having money left over for social programs that are worthy but are being starved along with everything else in a high unemployment economy.

The biggest gains at full employment, though, are realized in the private sector. Leaving \$50 billion out for state and local tax take, there remains one-quarter of a trillion dollars in aftertax private income. This is equivalent to the economy of Canada. The \$400 billion we are losing now because of the mismanagement of the economy is about equal to the output of California.

It is not possible, though, in the world inhabited by the Deficit Theorists for the economy to increase its real output of goods and services by \$400 billion from where it is today. David Stockman's computer model at the Office of Management and Budget is only capable of projecting deficits of those colossal amounts into 1985 and beyond. "None of us really understands what's going on with all these numbers," Stockman told the Atlantic Monthly. Everyone now agrees that the projected federal deficit for fiscal 1983 is \$182 billion. Where did that number come from and what does it imply about the future of the economy?

The projections come out of a computer model built by the same people who built Herb Stein's model when he was in Government, i.e., "demand-siders," otherwise known as "Phillips Curvers." In this model, it is not possible for an economy at 9 percent unemployment to get to 4 percent unemployment, at least not without a horrendous "inflation." In the Stockman computer model, the

best thing that can happen to an economy afflicted with a Deficit that is keeping interest rates high is a bunch of inflation. With rising prices and tax-bracket creep, the computer can clickety-clack zooming federal revenues that swallow up the projected deficits. Kellner, Jones, Yardeni, Kaufman et al would presumably tell us that the elimination of projected deficits in this fashion would encourage the bond market. But Deficit Theorists usually insist on making ad hoc pronouncements, without any known standard of evidence or logic against which their pronouncements can be tested.

The OMB computer model, which projects this \$182 billion deficit in fiscal 1983, does so largely based on the following assumptions: (1) the inflation rate will be low, preventing revenues from rising via bracket creep, etc.; (2) economy growth will be anemic because — in a demand-side computer — you can't have high growth and low inflation simultaneously, and assumption (2) must conform to assumption (1); (3) real interest rates will remain high, adding greatly to the cost of debt service.

Assumption (3) is interesting in a special way because it *implies* a high federal deficit! As OMB put it on page 2-15 of the budget document:

Interest costs are expected to be especially burdensome in the next few years because interest rates are expected to remain high relative to inflation. Interest rates reflect borrowers' expectations about inflation. These expectations, reflecting the inflationary fiscal and monetary policies of the last decade, can be expected to adjust only slowly to the disinflationary policies currently in effect.

The end of inflation, we see in this model, has three major effects. It raises the federal deficit by reducing revenues. It increases federal expenditures for debt service because of past "expectations" effects. And it reduces the level of economic growth below what it would be with higher inflation rates.

This is the model that has Senator Domenici seeing red all over Capital Hill, Senator Dole gnashing his teeth, James Baker III and Howard Baker, Jr., foaming at the mouth. And it is this nitwit computer that is the central source of all the silly deficit projections in Washington.

This doesn't mean we will not have a \$182 billion deficit as projected. We would have one and then some if the same minds that devised the computer program were put in charge of national economic policy. To put it another way, if Kellner, Jones, Yardeni, Kaufman, Greenspan, et al, were in charge of national economic policy, we would have to assume that their policy prescriptions would have the same effect as they did in 1932, when the earlier cohort of Deficit Theorists moaned and groaned about the effect of projected deficits on the financial markets and pushed through the tax hikes that did produce the deficits. To put it another way, we might say that Kellner, Jones, Yardeni, Kaufman and Greenspan have been in charge of national economic policy except for President Reagan. The Deficit Theory long ago swallowed Stockman via Alan Greenspan and Henry Kaufman. It has now twice come close to swallowing up President Reagan and the Mob has not given up. As we observed, while the "compromise" broke down, Reagan did come out of the negotiating process with the Deficit Theory wedged in his head: It's imperative that we enact a Federal budget that will bring down deficits and bring down interest rates."

Senator Domenici has every right to be encouraged. Reagan's willingness to "go the extra mile" revealed to Domenici not only Reagan's infection by the DT, but also a frontier against which the Mob can push: the President's willingness to raise "taxes" by \$122 billion over the Fiscal 1983-85 period. As in 1932, the "wisdom" of raising taxes is no longer being debated — except among the supply-side "backbenchers and mavericks." The notion that taxes won't be increased in a recession year that is an election year to boot also must be weighed against the reality of the 1932 Revenue Act, coming in a recession year that was also a *Presidential* election year. Then, as now, the President was a Republican, the Senate controlled by Republicans, the House controlled by the Democrats.

Given all these parallels, the chances that history would repeat itself this year have to be very low. Hollywood would never buy a movie script based on these improbabilities. Besides, the main actor is not a Hoover establishmentarian but a Coolidge populist. Fifty years ago next month he graduated from Eureka College, Illinois, with a sheepskin in supply-side economics. The Revenue Act of 1932 had just been signed into law and the Dow-Jones Industrial Average within weeks, on July 8, 1932, hit its low for the century, 41. The "index" could then buy two ounces of gold, so that if the parallels held up, and Reagan does get swallowed up by the Deficit Theorists, the DJI would test a low of 700, a dollar index number double the current gold price.

The only thing standing in the way of this dismal scenario is the contingent of House Republicans led by Jack Kemp and now Rep. Newt Gingrich of Georgia, who have mobilized all but a minority of their colleagues against the Mob of Deficit Theorists. Jim Baker, who is masterminding the budget "negotiations" from the White House, can really get nowhere as long as this opposition exists. Tip O'Neill and the House Democratic strategists in the end spurned the Reagan \$122 billion "compromise" because it did not guarantee an outflanking of the younger GOP House members.

To accomplish this, the Democrats must now get the \$122 billion established as the baseline for future negotiations. If they can get the House GOP leadership to accept the hoked-up \$182 billion deficit projection, one thing will lead to another and we will have a big tax bill, even the Kemp-Gingrich coalition melting to a hardcore of bankbenchers and mavericks. The Washington press corps is dutifully doing its job of reporting the \$182 billion projection as if it were already engraved in history.

The longer the delay, the better, because the Mob eventually will be overwhelmed by reality. There is already a problem of where to hide the revenues piling up in Treasury in fiscal 1982, with OMB constantly embarrassed as its monthly upward adjustments become obsolete in a matter of weeks and new excuses have to be found on why good news now means worse news later. The deception going on in this game rivals the field in the Kentucky Derby for the Pinocchio Award of 1982 (although Stockman would win by more than a nose). Once you start, you just can't stop.

The President himself is trapped in the White House, held prisoner by his staff. They are apparently so determined to save the country from Ronald Reagan and "voodoo economics" that he is swamped with Deficit Theorists, breakfast, lunch and dinner. The occasional minute or two he gets with a Kemp, never alone, are overwhelmed by the constant pounding from the Mob. The only thing

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THE DEFICIT THEORY

that gets through this screen are prayers and Cable Network News, which covers the proceedings of the House on C-Span and which Reagan at times watches. He called Gingrich and several other young Republicans late in the evening recently after seeing the C-Span tapes of their anti-tax speeches, offering congratulations and well-done.

The Mob doesn't know how far it can move Reagan and keep Kemp from blowing up, which would cause unforeseen problems at the White House. Kemp on April 30 was quoted on the front page of the *Washington Post*, warning that Reagan had come "dangerously close" to abandoning all of his supply-side principles (and supporters).

Meanwhile, we wait. The first paychecks of July are important, providing political relief, a payoff for Reagan's stubbornness in resisting the Mob so far. The Mob probably has to get its way before those first paychecks, reflecting the 10 percent cuts. At the same time, we watch the price of gold, now hoping that Volcker is keeping his eye on it too. Since March 17, when I called him and pleaded that he not let the price fall below \$300, because of the deflationary implications, the gold price climbed from its low that day of \$312 to about \$375 (according to the demand-siders because of the Falkland Islands). But it has since hovered around \$350, which is where I would like to see it stay. If Volcker spends one minute more every day thinking about the price of gold and one minute less each day thinking about M1, every day we will be one minute closer to a gold standard and a steady decline in interest rates. A minute at a time, and before you know it, Stockman (or his successor) will be projecting budget surpluses.

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